

Proprietary hospital acquired by nonprofit corporation. The purchase, in a transaction not at arm's length, of all of the assets of a profit-making hospital by a nonprofit hospital corporation at a price that includes the value of intangible assets, determined by the capitalization of excess earnings formula, does not result in the inurement of the hospital's net earnings to the benefit of any private shareholder or individual or serve a private interest precluding exemption under section 501(c)(3) of the Code.

Advice has been requested whether a nonprofit hospital that acquires certain property in the manner and under the circumstances described below qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954.

The owners of X hospital, a profitmaking institution, created Y, a nonprofit corporation, to purchase and operate the hospital. Over one-half of the board of directors of Y consists of stockholders in X. Although Y will operate the hospital in a charitable manner in accordance with section 501(c)(3) rather than on a proprietary basis, the operation of the facility and the type of service provided will remain essentially unchanged.

Y's creating instrument meets the organizational requirements of section 1.501(c)(3)-1(b) of the Income Tax Regulations, including the limitation of its purposes to those described in section 501(c)(3) of the Code and the dedication of its assets to such purposes.

In order to establish the selling price of the hospital, the owners obtained an independent appraisal of the tangible assets and then computed the value of the intangible assets by the capitalization of excess earnings formula as set forth in Rev. Rul. 68-609, 1968-2 C.B. 327. The value of the intangible assets by this method was substantial.

Y purchased the hospital for the price arrived at by the above method. Such price represents the fair market value of the tangible and intangible assets.

Y submitted evidence establishing that the intangible assets have a direct and substantial relationship to the performance of the exempt functions of the hospital.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(c) of the regulations defines the term

'private shareholder or individual' as any person having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized exclusively for one or more charitable purposes unless it serves a public rather than a private interest.

Generally, where an organization purchases assets from an independent third party, a presumption exists that the purchase price (arrived at through negotiations) represents fair market value. However, where the purchaser is controlled by the seller (or there is a close relationship between the two) at the time of the sale, this presumption cannot be made because the elements of an arm's length transaction are not present.

In situations where there is common control of or a close relationship between the buyer and seller and both tangible and intangible assets are being purchased, the value of the tangible assets must first be established by independent appraisal. The purchaser must then establish the components of the intangible assets, indicate how these components will be used to further its exempt purposes, and establish the aggregate value of these intangibles.

In the case of a hospital, accreditation for an internship or residency program, good labor relations, an active medical staff, and a favorable location, are some factors that might have intangible value and enable a hospital to carry on a public service function more efficiently.

Where an organization claiming exemption from Federal income tax under section 501(c)(3) of the Code purchases intangible assets for a use that is directly and substantially related to its exempt purpose, the capitalization of excess earnings formula is an acceptable method of determining their value. In the present case, Y has established that the hospital it acquired has intangible assets and that the hospital will continue to be operated in a manner to provide essentially the same services it had previously. In these circumstances, the intangible assets will contribute directly and substantially to the accomplishment of Y's exempt purposes, and, therefore, it is appropriate for Y to value them by means of the capitalization of excess earnings formula. Thus, the purchase of the intangible assets of X by Y did not result in the inurement of Y's net earnings to the benefit of any private shareholder or individual, nor did the transaction serve a private rather than a public interest.

Accordingly, Y qualifies for exemption from Federal income tax under section 501(c)(3) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023,

Application for Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See sections 1.501(a)-1 and 1.508-1(a) of the regulations.